SV Wealth - Newsletter

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2022: From Dusk to Dawn

Happy New Year! As we look ahead to what's in store for the year ahead, it's always good to take a moment and reflect on what we experienced over the past twelve months.

2022 started on a high note, fueled by optimism that the pandemic was finally behind us and life was getting back to normal. The S&P 500 was at record highs and although inflation was stubborn, central banks around the world assured us that it was "transitory", a by-product of the post-Corona reopening.

As the year moved forward, it became increasingly clear that inflation was more stubborn than anticipated. Russia's invasion of Ukraine last February aggravated the situation further. Wage inflation was especially worrisome, with entry-level jobs paying people just to show up for interviews and their first week of work.

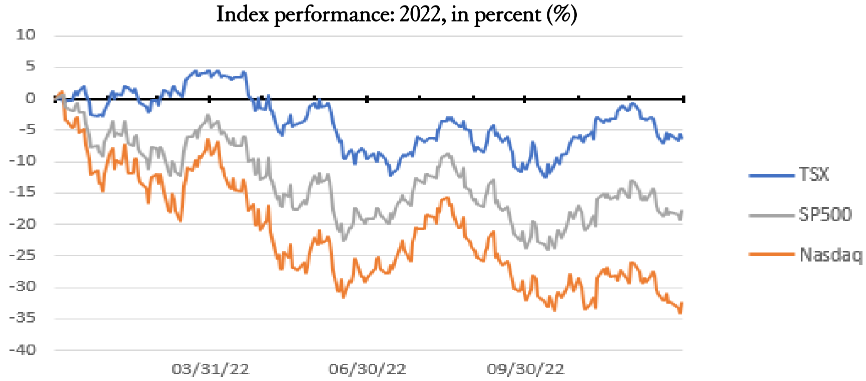
Once central banks got serious about inflation in the spring, they began a very aggressive tightening cycle, pushing interest rates from near 0% to more than 4% by year-end. As the rate hikes started to bite in the economy, the stock market began to tank in anticipation of the slower growth that lay ahead.

Bank of Canada Overnight Lending Rate

Source: Bloomberg, Financial Post.

For the year, all the major indices were down. The broad-based S&P 500 fell nearly 20% while the technology-heavy Nasdaq was down 33%. In Canada, the TSX Composite fared better than our southern neighbors on account of our energy exposure, closing the year down a little under 7%.

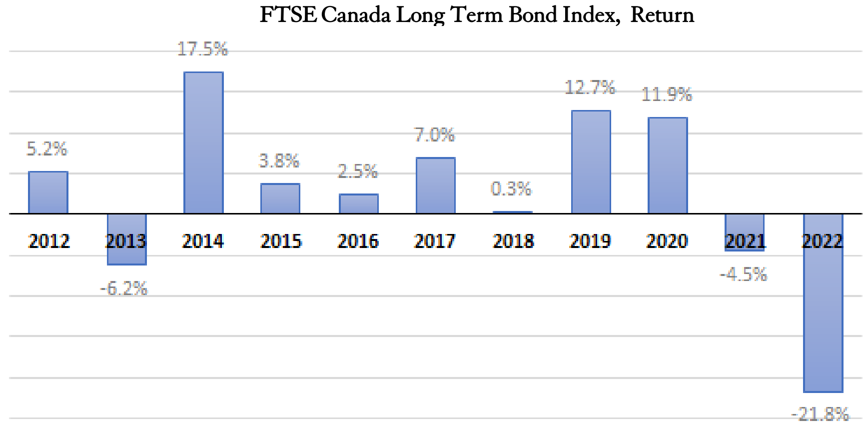
Index performance: 2022, in percent (%)



Source: SV Wealth, FactSet.

2023: The Year of Fixed Income

As central banks tightened rates, fixed income also had a rough year since newly issued bonds offered coupon rates higher than existing bonds. This was despite the fact that bonds are typically expected to outperform stocks in a contracting economy.



Source: Raymond James Ltd, Morningstar, FactSet

With the reset in fixed income taking place last year, one corner of the market that currently offers a compelling opportunity is the preferred share market. Preferreds suffered along with bonds but have a unique trait in that they allow for participation in price appreciation.

Preferred shares are currently offering a yield of more than 6%, which is equal to the average rate of return of the TSX Composite over the last ten years (roughly 6.5%). Thus, owning preferred shares of quality companies provides cash flow similar to bonds while offering upside capital gain potential of 20-25%.

We believe that central banks have finished their rate-raising cycle for the most part, and their plan now is to maintain rates at the current levels. With stable rates, owning Prefs allows us to get paid while waiting for the economic storm to pass.

The opportunity of such an attractive setup in fixed income has not been seen in quite a while. We continue to hedge our dividend-paying stocks by adding preferred shares, giving us a solid cash flow for our portfolio.

Potential Risks Ahead

The big risk for 2023 is a recession triggered by interest rates that moved upwards at unprecedented speed. Since rate hikes take time to move through the economy, there remains a fear that we haven't seen the full impact play out in the real economy yet.

Despite the headwinds, we remain invested in quality companies with solid businesses that pay stable dividends. By adding exposure to preferred shares, we believe 2023 will indeed be the year of fixed income.